



**Testimony before the Assembly Committee on Financial Institutions on
AB 850 (SB 604), defining the political subdivision of a state for
purposes of the Wisconsin Uniform Securities Law**

March 24, 2010

Chairman Fields and fellow members of the Assembly Committee on Financial Institutions, thank you for holding a public hearing on Assembly Bill 850.

The legislation we are discussing here today is quite simple. It clarifies that school districts are not sophisticated institutional investors for purposes of the Wisconsin Uniform Securities Law. The law allows certain employee benefit plans administered by government entities, or political subdivisions, to be exempt from many of the requirements we have in place to make sure the funds in those government employee benefit plans are invested wisely and conservatively. The idea is that those administering large employee plans are generally sophisticated investors who have the special expertise necessary to properly vet and prudently invest in a broader range of investments, like stocks and more exotic investments.

Representative Steinbrink, Senator Wirch and I do not believe that the legislature ever meant that school district benefits funds, overseen by our local school boards, were meant to be covered by the exemptions for

political subdivisions as sophisticated investors. Our state's school boards are basically run by folks who are essentially volunteers, not full-time employees, let alone investment professionals. They are not the sophisticated institutional investors meant by that portion of the Uniform Securities Law exempting political subdivisions. We believe the change proposed in this law clarifies that.

Mr. Joseph Kiriaki from Kenosha will testify about the bad experience the Kenosha Unified School District had when its board was misled into believing that it was investing in securities that met the state's standard under the law. We and he feel strongly that the legislature needs to send a message to the state's school districts that school boards are not exempt as sophisticated institutional investors. Kenosha Unified, along with the school districts of Waukesha, South Milwaukee-West Allis, Whitefish Bay and Kimberly, is currently involved in litigation about the bad investment and we want to avoid this ever happening again. This legislation is intended to make clear to school districts, their investment advisors and any lawyers and judges looking into these matters that school districts are not meant to be exempt as "political subdivisions".

This bill is a first step. We have looked into including other smaller local political entities, such as townships, the kind that are usually run by volunteers, and considered including them in this proposal. However, in the interest of time and due to the problems that presented, we feel that for now, school districts, due to their larger public benefits funds but volunteer boards, are the most important to address. They are not the sophisticated investors envisioned in the law and we want to clarify that with this bill.

MY NAME IS BILL BROYDRICK AND I AM APPEARING TODAY, FOR INFORMATION PURPOSES ONLY, ON AB850.

I REPRESENT DEPFA BANK AND WANT TO GIVE THE COMMITTEE SOME BACKGROUND AND FACTUAL CONTEXT ON WHY THIS BILL IS BEFORE YOU TODAY.

IT IS PART OF A DISPUTE BETWEEN FIVE WISCONSIN SCHOOL DISTRICTS—KENOSHA, WAUKESHA, WEST ALLIS-WEST MILWAUKEE, WHITEFISH BAY AND KIMBERLY, AND THE ROYAL BANK OF CANADA AND STIFEL NICOLAUS—CONCERNING APPROXIMATELY \$200 MILLION WORTH OF COLLATERALIZED DEBT OBLIGATIONS (CDOS) THAT WERE SOLD BY RBC AND STIFEL NICOLAUS TO THE FIVE SCHOOL DISTRICTS. TODAY THOSE CDOS ARE VIRTUALLY WORTHLESS.

WHO IS DEPFA BANK AND HOW ARE THEY INVOLVED?

DEPFA BANK PLC IS A DUBLIN-BASED BANK, INCORPORATED UNDER IRISH LAW. DEPFA IS A SUBSIDIARY OF THE GERMAN HOLDING COMPANY: HYPO REAL ESTATE HOLDING AG,

DEPFA BANK SPECIALIZES IN STATE FINANCING AND HAS BEEN ACTIVE IN THAT CAPACITY IN THE UNITED STATES FOR A NUMBER OF YEARS. DEPFA HAS HAD THE STATE OF WISCONSIN AS ITS CUSTOMER FOR MANY YEARS AND VIEWS ITS MANDATE AS ONE TO SUPPORT PUBLIC ENTITIES THROUGH FINANCE. DEPFA WAS AN EARLY INVESTOR IN PENSION OBLIGATIONS ISSUED BY STATE AND LOCAL AUTHORITIES, INVESTING IN THESE OBLIGATIONS WHEN OTHER INVESTORS WERE NOT.

IN 2006, DEPFA LOANED THE FIVE SCHOOL DISTRICTS AROUND \$165 MILLION DOLLARS IN CONNECTION WITH THE SCHOOL DISTRICTS' EFFORTS TO FUND FUTURE EMPLOYEE BENEFITS.

WHAT WERE THE SCHOOL DISTRICTS TRYING TO ACCOMPLISH WITH THE MONEY LOANED?

THEY INTENDED TO TAKE THE PROCEEDS FROM OUR LOAN AND BUY CDOS, WHICH WOULD EARN 100 BASIS POINTS OR 1% IN PROFIT. THEY ESTABLISHED POST-EMPLOYMENT BENEFITS TRUSTS, WHICH WERE DESIGNED TO PAY THE COST OF BENEFITS, PRINCIPALLY HEALTH INSURANCE, WHICH HAS BEEN NEGOTIATED BETWEEN THE DISTRICTS AND TEACHERS UNION. FOR EXAMPLE, IF A TEACHER RETIRES UNDER THE AGE OF 65, THE DISTRICT TYPICALLY PAYS HEALTH INSURANCE UNTIL THEY ARE ELIGIBLE FOR MEDICARE. AFTER 65, THE DISTRICT TYPICALLY PAYS THE COST OF THEIR MEDICARE SUPPLEMENTAL INSURANCE. THE TRANSACTIONS WERE ULTIMATELY PUT TOGETHER BY STIFEL NICOLAUS.

STIFEL NICOLAUS APPROACHED DEPFA REGARDING THE LOANS. STIFEL PRESENTED THE DEALS TO DEPFA AS PENSION OBLIGATION DEALS, UNDER WHICH DEPFA WOULD HAVE A MORAL OBLIGATION PLEDGE FROM EACH OF THE SCHOOL DISTRICTS. DEPFA PLAYED NO ROLE IN RECOMMENDING INVESTMENTS TO THE SCHOOL DISTRICTS. THE SCHOOL DISTRICTS DECIDED ON THEIR OWN TO PURCHASE THE CREDIT DEFAULT SWAPS.

THE DISTRICTS WERE GIVEN A VERY ADVANTAGEOUS LOW INTEREST RATE BY DEPFA FOR THEIR LOAN—3 MONTH LIBOR PLUS 18 BASIS POINTS. LET ME EXPLAIN. LIBOR IS SIMILAR TO THE FEDERAL RESERVE RATE AND REFLECTS THE LONDON-INTERBANK OFFERED RATE. 18 BASIS POINTS IS .18%. SO, IF LIBOR WERE 3 PERCENT, THE LOAN WOULD HAVE AN INTEREST RATE OF 3.18%.

WHY DID DEPFA OFFER SUCH A LOW RATE? SIMPLE. THE RATE REFLECTS THE RISK ATTACHED TO THE LOAN. THE SCHOOL DISTRICTS PLEDGED THEIR MORAL OBLIGATION THAT THEY WOULD PAY (MORE ABOUT THEIR PAYMENT IN A MOMENT).

MORAL OBLIGATION BONDS ARE A COMMON PRACTICE THROUGHOUT THE COUNTRY AND IN WISCONSIN. MANY OF THE WEDHA BONDS HAVE THE MORAL OBLIGATION OF THE STATE ATTACHED TO THEM. THE STATE HAS PLEDGED ITS MORAL OBLIGATION FOR THE MILWAUKEE PUBLIC SCHOOL BONDS THAT WERE USED FOR THE NEW SCHOOL INITIATIVE PROGRAM.

MORAL OBLIGATIONS ARE ALWAYS HONORED. THAT IS, THE GOVERNMENT-ENTITY-BORROWER TYPICALLY PAYS BACK ITS OBLIGATION. THE ONE EXCEPTION WE HAVE FOUND WAS IN THE CASE OF A MUNICIPAL PARKING STRUCTURE IN SPOKANE, WASHINGTON. THE CITY EVENTUALLY DID PAY ON ITS MORAL OBLIGATION, BUT ONLY AFTER LITIGATION AND SPENDING MILLIONS OF DOLLARS TRYING TO AVOID PAYMENT.

THE PROBLEM IS THAT THE MARKET FOR CDOS DETERIORATED BY THE END OF 2007, AND EVEN MORE SUBSTANTIALLY IN 2008. NOW THE CDOS ARE WORTH LITTLE. THE DISTRICTS DID NOTHING TO ADDRESS THE ERODING VALUE OF THE CDOS, EXCEPT TO START A LAWSUIT.

BY THE WAY, THE FIVE SCHOOL DISTRICTS ALSO TOOK APPROXIMATELY \$35 MILLION DOLLARS OF PROPERTY TAX MONEY AND ALSO INVESTED THE MONEY IN CDOS—ALONG WITH THE MONEY THAT THEY RECEIVED AS A LOAN FROM DEPFA.

THE SCHOOL DISTRICTS DID THE FOLLOWING:

KENOSHA TOOK \$9.5 MILLION OF PROPERTY TAXPAYER DOLLARS AND BORROWED FROM US \$28 MILLION,

WAUKESHA TOOK \$15.7 MILLION OF PROPERTY TAXPAYER MONEY AND BORROWED FROM US \$65 MILLION,

WEST ALLIS-WEST MILWAUKEE TOOK \$10.9 MILLION OF PROPERTY TAXPAYER MONEY AND BORROWED FROM US \$82.5 MILLION—TEN OF WHICH WAS REPAID THROUGH A SUBSEQUENT BOND ISSUE,

WHITEFISH BAY TOOK \$500,000 OF PROPERTY TAXPAYER DOLLARS AND BORROWED FROM US \$10 MILLION DOLLARS,

AND KIMBERLY TOOK \$800,000 DOLLARS OF PROPERTY TAXPAYER DOLLARS AND BORROWED FROM US \$5 MILLION.

SO THE TOTAL WAS A CONTRIBUTION OF APPROXIMATELY \$35 MILLION IN PROPERTY TAXPAYER DOLLARS AND A LOAN OF APPROXIMATELY \$165 MILLION, FOR A TOTAL OF APPROXIMATELY \$200 MILLION.

YOUR COLLEAGUE, REPRESENTATIVE STRINKBRINK, ALSO SERVES AS THE VILLAGE PRESIDENT OF PLEASANT PRAIRIE, WHICH IS IN THE UNITED KENOSHA SCHOOL DISTRICT. THEY HELD A HEARING QUESTIONING THE WISDOM OF THE INVESTMENTS. THE PLEASANT PRAIRIE FINANCIAL ADVISOR WAS THE FORMER BUSINESS MANAGER OF THE KENOSHA SCHOOL DISTRICT. HE WARNED THAT WHAT HAS ACTUALLY HAPPENED WAS IN THE PROCESS OF HAPPENING. A KENOSHA SCHOOL BOARD MEMBER AND THEIR BUSINESS MANAGER DEFENDED THE TRANSACTION. THE PUBLIC IN KENOSHA SPOKE AND, AT THE SUBSEQUENT SCHOOL BOARD ELECTION, THE MEMBER WHO DEFENDED THE ACTION RAN LAST AND WAS DEFEATED. THE BUSINESS MANAGER IS STILL THE BUSINESS MANAGER OF KENOSHA UNIFIED.

I WILL LEAVE IT TO THE PROPONENTS OF THE BILL TO EXPLAIN WHAT IT DOES.

THE SCHOOL DISTRICTS HAVE SUED RBC AND STIFEL NICOLAUS FOR FRAUD. DEPFA HAS NOT BEEN SUED.

THE LAWSUIT WAS FILED TWO YEARS AGO AND THE DISTRICTS, AS OF LAST OCTOBER, HAVE SPENT AN ADDITIONAL \$1.3 MILLION ON LEGAL FEES THUS FAR. RBC HAS ATTEMPTED, UNSUCCESSFULLY, TO MOVE THE CASE TO FEDERAL COURT. RBC AND STIFEL NICOLAUS ALSO SOUGHT DISMISSAL OF THE CASE FROM THE LOCAL MILWAUKEE COUNTY JUDGE, ALBEIT UNSUCCESSFULLY. STIFEL NICOLAUS HAS COUNTERSUED.

MEANWHILE, THE FIVE SCHOOL DISTRICTS, WHICH PLEDGED THEIR MORAL OBLIGATION, HAVE NOT GIVEN ANY INDICATION THAT THEY INTEND TO HONOR THEIR OBLIGATION.

WHAT ARE THE CONSEQUENCES OF THEIR NOT PAYING?

WHAT HAPPENS TO YOU IF YOU DON'T PAY BACK A LOAN?

NOTHING GOOD COMES FROM ANY OF US NOT MEETING OUR FINANCIAL OBLIGATIONS.

FURTHERMORE, IT WILL BE DIFFICULT FOR THESE SCHOOL DISTRICTS TO RE-ENTER THE CAPITAL MARKETS.

INTERESTINGLY SEVERAL OF THE DISTRICTS DO PLAN TO RE-ENTER THE CAPITAL MARKETS.

RECENTLY, DEPFA DECLARED THE POST-EMPLOYMENT BENEFITS TRUSTS ESTABLISHED BY THESE FIVE SCHOOL DISTRICTS TO BE IN DEFAULT AND ACCELERATED PAYMENT OF THE LOANS, AFTER IT BECAME CLEAR THAT THEY WERE UNWILLING TO MEET THEIR RESPONSIBILITIES.

AS A RESULT, THE RATING AGENCIES AND THE CAPITAL MARKET MAY IMPOSE SOME MARKET DISCIPLINE BY PUTTING A PREMIUM ON THEIR BORROWING, IF THEY ARE ABLE TO BORROW AT ALL.

THIS ACTION ON THEIR PART MAY ALSO AFFECT OTHER SCHOOL DISTRICTS AND THE STATE. BUT AT THIS POINT, WE JUST DON'T KNOW.

ALSO, MANY STATES, INCLUDING WISCONSIN, ARE INTERESTED IN ENTERING THE EUROZONE TO RAISE MONEY.

WE WOULD LIKE TO WORK OUT SETTLEMENTS WITH THESE SCHOOL DISTRICTS, BUT TO DATE THE DISTRICTS HAVE OPTED TO CONTINUE SPENDING TAXPAYER MONEY ON LEGAL FEES WITHOUT ANY ASSURANCE OF SUCCESS.

WISCONSIN EDUCATION ASSOCIATION COUNCIL

Affiliated with the National Education Association

**Testimony of Joe Kiriaki, Executive Director
Kenosha Education Association
Assembly Committee on Financial Institutions
AB 850**

March 24, 2010

*Great Schools
benefit
Everyone!*

My name is Joe Kiriaki, I am the Executive Director of the Kenosha Education Association.

I am here today to testify in support of Assembly Bill 850 to institute more accountability and transparency in investment transactions involving school districts to fund Other Post-Employment Benefits.

For me, this bill gets to a matter of basic fairness. And since the victims from this bad investment scheme that I will talk about today are school children, it is also a matter of safeguarding our communities' future. Leaving our schools in the lurch is a classic example of bending over a dollar to pick up a quarter. I don't want us to have to pay for this neglect many times over in the future.

Let me provide you with some background information. In 2006, legislation was enacted that permits school districts to establish trust funds for the purpose of borrowing and investing money to help fund what is commonly referred to as Other Post-Employment Benefits or OPEBs (2005 Wisconsin Act 99). OPEBs can include a variety of post-employment benefits (non-pension), but the largest portion of OPEB obligations stem from post-employment health benefits. The idea of this legislation was to provide school districts with greater financial flexibility to fund their OPEB obligations. The new law required that funds must be invested in accordance with the Wisconsin Uniform Prudent Investor Act Section 881.01 of the Wisconsin Statutes. Instead of spending money from operating funds, benefits would be paid from a trust. Also, for the first time, districts could hire fund managers to operate the trusts and make investment decisions.

Mary Bell, President
Dan Burkhalter, Executive Director



With the new law, investment companies saw a new opportunity to market products to meet the needs of school districts that wanted to account for their current and future OPEB costs and to prevent an erosion of their credit ratings. Shortly after the new law took effect, five Wisconsin school districts, Kenosha, Kimberly, Waukesha, West-Allis and Whitefish Bay, were approached by the Stifel Nicolaus & Company, their long-time financial advisor, regarding a new product that could be used to help fund the districts' OPEB obligations. The product was called the GOAL Program [Government OPEB Asset & Liability Program].

The GOAL program involved investment in unregistered credit derivatives called "Credit-linked Notes". These notes were designed to perform like synthetic collateralized debt obligations and were to be purchased mainly with borrowed funds. In a simplistic sense, the program involved borrowing funds at a lower rate and investing those funds in instruments earning a higher rate. Through Stifel Nicolaus & Company, the districts sought bids from financial companies for investments with these parameters, and ultimately chose a product available through the Royal Bank of Canada (RBC). The districts borrowed money from DEPFA, a foreign bank, as well as putting up some of their own assets to purchase the financial instruments from the RBC. All together the districts borrowed \$165 million and put up another \$35 million of their own money.

The GOAL program fell victim to the economic meltdown in 2008. By the end of 2008, the investments' value was estimated to have dropped by \$190 million with some of the investments being deemed completely worthless. The school districts, their communities and school district staff are left holding the bag for what's owed on the loans, as well as their lost assets.

In a lawsuit filed by the five districts against the Stifel Nicolaus Company, the school districts contend that they made the investments because, in relying on representations made by Stifel Nicolaus Company, they believe that the investment risk involved was the same as buying a diversified portfolio of corporate bonds. In other words, they believed that the investments were exactly the sort of thing contemplated by the new

law and the Wisconsin Uniform Prudent Investor Act. They believed they were acting responsibly and that the risks involved were minimal. It's clear now that the involved school boards had very little understanding of the true nature of the product in which they invested or its potential risks.

The question of to what degree the end result was effectuated by the misrepresentations of the Stifel Nicolaus Company or the misjudgment of the five school boards and administrative staff involved will ultimately be answered by the courts. The question for the State of Wisconsin and the state legislature is "what should be done to prevent this from happening again in the future?"

The legislation before you today, Assembly Bill 850, will not fix our banking system or change the underlying motives of the business practices that led our country into the financial collapse and the recession that followed. It also may not fully address many of the problems that can arise under 2005 Wisconsin Act 99. This legislation does represent an important first step in ensuring that what happened in Kenosha and the other four districts does not happen again.

I was at the court hearings regarding the five districts' lawsuits and heard where the lawyers argued that the brokerage firms were able to sell these unregistered and highly risky securities to the districts because the districts (and their OPEB Trusts) are, in their view, political subdivisions of the state. I heard attorneys for the districts argue that the term Political Subdivision is defined 48 times in the statutes to mean "city, county, town or village" and that school districts are never included in the definition. While I do not agree that the defendants are correct, I am merely asking for clarity and for the legislature to resolve an ambiguity because the term "political subdivision" was not defined in 551. This is what the investment companies are trying to exploit. What's done is done and now it is a matter for the lawyers to argue and the judge to decide. But let's not leave that ambiguity going forward. Let's make your intent clear. School districts are not now and never have been political subdivisions of the state.

By clarifying that school districts are not political subdivisions within the limited scope of Section 551.102, Wisconsin Statutes, you can eliminate any ambiguity in the law that currently allows persons, including broker-dealers and investment advisors, to avoid state requirements to register themselves as brokers and advisors in certain situations, as well as registering the securities they sell with the Division of Securities (division) in the Department of Financial Institutions. With registration comes responsibility and transparency, as well as a regulatory framework for preventing fraudulent practices. There is no way to know for sure whether this requirement would have protected the five school districts from the losses they incurred, but why take the chance going forward?

Our schools should be first in line when it comes to distributing public resources, but as it is they are getting shut out by the very bankers who created this financial burden in the first place.

Schools are the real investments. Those investments deserve protection. Let's protect our investments by passing this bill.

For all of these reasons, I ask you to support AB 850.

Thank you.